100TH CONGRESS
*2d Session*

SENATE

EXEC. REPT.
100-23

# TAX CONVENTION WITH THE UNITED KINGDOM (ON BEHALF OF BERMUDA)

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## REPORT

OF THE

## COMMITTEE ON FOREIGN RELATIONS
## UNITED STATES SENATE

ON

THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND (ON BEHALF OF THE GOVERNMENT OF BERMUDA) RELATING TO THE TAXATION OF INSURANCE ENTERPRISES AND MUTUAL ASSISTANCE IN TAX MATTERS, WITH A RELATED EXCHANGE OF NOTES, SIGNED AT WASHINGTON ON JULY 11, 1986

SEPTEMBER 22, 1988.—Ordered to be printed

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Mr. PELL, from the Committee on Foreign Relations, submitted the following

## REPORT

[To accompany Treaty Doc. 99-30]

The Committee on Foreign Relations, to which was referred the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on Behalf of the Government of Bermuda) Relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, with a related Exchange of Notes, signed at Washington on July 11, 1986, having considered the same, reports favorably thereon with two reservations and recommends that the Senate give its advice and consent to ratification thereof.

## I. PURPOSE

The principal purpose of the proposed tax treaty between the United States and Bermuda is to promote continued close political and economic cooperation between the two countries by providing certain U.S. tax reductions. The proposed treaty is also intended to enable the countries to cooperate in preventing avoidance and evasion of U.S. taxes.

## II. BACKGROUND

The proposed treaty with Bermuda was signed on July 11, 1986, and was amplified by an exchange of notes signed the same day. No similar tax treaty between the two countries is currently in force.

The treaty was transmitted to the Senate for advice and consent to its ratification on September 10, 1986. The Senate Committee on Foreign Relations held a public hearing on the proposed treaty on September 25, 1986.

## III. SUMMARY

The proposed treaty between the United States and Bermuda relating to the taxation of insurance enterprises and mutual assistance in tax matters limits U.S. taxation of Bermuda-based insurance enterprises. This objective would principally be achieved by each country agreeing not to tax the business profits of insurance enterprises of the other country unless such enterprises carry on (or have carried on) business in the first-mentioned country through a permanent establishment there. Such an agreement, coupled with certain other features of the treaty, would eliminate the Federal excise tax on certain insurance and reinsurance premiums paid to Bermuda-based insurers of U.S. risks.

The two reservations adopted by the Committee narrow the scope of the excise tax exemption and sunset it entirely effective with respect to premiums paid or credited on or after January 1, 1990.

The proposed treaty, as amplified by the accompanying diplomatic notes, provides in addition for mutual assistance in tax matters, including the exchange of information. The notes indicate that the Treasury Department is prepared to certify that the treaty's mutual assistance provisions carry out the purposes of the provision of the Tax Reform Act of 1984 that conditions a foreign country's eligibility as a situs for Foreign Sales Corporations on the existence of a certified exchange of information agreement between the United States and that country. Thus, under the treaty, U.S. taxpayers will be able to obtain Foreign Sales Corporation tax benefits by exporting through qualifying companies organized in Bermuda. According to the notes, the Treasury Department is also prepared to enter into an executive agreement with Bermuda incorporating the treaty's mutual assistance and confidentiality rules, which will allow persons incurring expenses for attending business conventions in Bermuda to claim U.S. tax deductions for those expenses as though the conventions had been held in the United States.

Like other U.S. tax treaties, the proposed treaty contains a "saving clause." Under this provision, the United States retains the right to tax its citizens and residents as if the treaty had not come into effect. The treaty also contains a nondiscrimination provision protecting permanent establishments of insurance enterprises.

## IV. DATE OF ENTRY INTO FORCE AND TERMINATION

### Entry into force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country. The treaty states that instruments of ratification are to be exchanged as soon as possible. However, in the notes amplifying the treaty, the United States observed that, under Bermuda's legal system, the treaty is not self-executing and that legislation would be required to implement the treaty. Bermuda expressed the understanding that instruments of ratification would not be exchanged until such legislation as may be required to implement the treaty had been enacted.

The treaty is to enter into force upon the exchange of instruments of ratification and its provisions are to take effect as follows: With respect to the U.S. excise taxes on insurance premiums paid to foreign insurers, the treaty applies retroactively to premiums paid or credited on or after January 1, 1986. With respect to income taxes imposed on the business profits of an insurance enterprise, the treaty applies to profits derived in taxable years beginning on or after the first day of the calendar year in which the treaty enters into force.

The treaty provision governing mutual assistance in the prevention of tax fraud and tax evasion generally applies to taxable years not barred by the statute of limitations of the country requesting assistance. However, neither country is required to provide assistance with respect to taxable years beginning prior to January 1, 1977.

The provision governing mutual assistance in carrying out the fiscal laws of the two countries other than those relating to tax fraud and tax evasion also generally applies to taxable years not barred by the statute of limitations of the country requesting assistance. However, neither country is required to provide assistance under this provision with respect to taxable years beginning prior to the entry into force of the treaty if such assistance would result in the breach of an obligation to maintain confidentiality of information under the laws of the country to which the request is made on the date of signature of the treaty. Neither country is required to provide assistance under this provision in any circumstances with respect to taxable years beginning prior to January 1, 1977. The diplomatic notes accompanying the treaty (discussed below) elaborate further on when the mutual assistance provision discussed in this paragraph becomes effective.

**Termination**

The proposed treaty will continue in force indefinitely, but either country may give notice of termination to the other country on or after June 30th of the year following the calendar year in which the treaty enters into force. If such notice of termination is given, the treaty will terminate on the first day of the seventh full calendar month following the month in which the notice is given.

## V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed Bermuda tax treaty on September 25, 1986. The Committee considered the proposed treaty on September 14, 1988, and ordered it favorably reported by a voice vote, subject to two reservations that are described below, with the recommendation that the Senate give its advice and consent to ratification thereof, subject to the reservations.

## VI. COMMITTEE COMMENTS

***In general***

The Committee on Foreign Relations recommends that the Senate give its advice and consent to ratification of the treaty, sub-

ject to two reservations, because the treaty will promote continued close economic, political, and military cooperation between the United States and Bermuda. Important national security interests are served by strong and positive relations between the United States and Bermuda. In addition, the Committee believes that the mutual assistance provisions of the treaty, particularly exchange of information provisions, will be of significant benefit to U.S. tax authorities in their efforts to enforce U.S. tax laws. However, the Committee did express its concern with respect to several issues raised by the treaty. Most fundamentally, the Committee was concerned about the reduction of income tax on U.S. income earned by residents of a jurisdiction which imposes no income tax. Because of this and other conerns, the Committee has recommended that the Senate give its advice and consent to ratification subject to two reservations which are described below.

***Insurance excise tax exemption***

The Committee was very concerned with Article 4 of the treaty to the extent it would have waived the excise taxes on insurance premiums earned by Bermuda companies insuring U.S. risks. The United States has made similar agreements in the past with other countries, in order to avoid subjecting insurance income to double taxation—once by the residence country and once by the source country. Since Bermuda levies no tax on the premiums collected or on the income realized by Bermuda insurers or reinsurers, the traditional rationale for an insurance premium excise tax waiver is not present.

In 1985, however, the United States entered into a tax treaty with Barbados which also waives the insurance excise tax. Barbados levies no tax on certain sectors of its domestic insurance industry. Since Barbados and Bermuda are competitors in the offshore insurance market, the Barbados treaty could have placed Bermuda at a serious competitive disadvantage in providing offshore insurance and reinsurance to U.S. insureds.

The Committee is mindful of the friendly relationship which has traditionally existed between Bermuda and the United States and wants to correct the competitive imbalance which was unintentionally created by ratification of the U.S.-Barbados treaty. At the same time, the Committee does not wish to redress the situation by placing U.S. insurers at a disadvantage with Bermuda companies providing insurance in the U.S. market.

In retrospect, the Committee believes the insurance excise tax provision should not have been entered into between the United States and Barbados. Accordingly, it has asked for and has received firm commitments from the Treasury and State Departments to renegotiate the Barbados treaty to eliminate its waiver of U.S. insurance excise tax by the earliest date permissible under the treaty, January 1, 1990.

Because of this commitment, the Committee recommends the Senate consent to the inclusion of the insurance excise tax provision in the Bermuda treaty as long as Bermuda, in turn, agrees to a reservation which will sunset the waiver of U.S. insurance excise tax by January 1, 1990. The combination of eliminating the waiver of U.S. insurance excise tax from the Barbados treaty by January

1, 1990, and sunsetting the waiver in the Bermuda treaty, will again restore the competitive position of these two nations and will, by January 1, 1990, eliminate the unfair advantages granted by these two treaties to Bermuda and Barbados insurance companies over U.S. insurance companies.

The Committee is apprehensive that even this limited period during which the insurance excise taxes will be waived may be used by Bermuda companies to gain substantial market advantages in U.S. insurance and reinsurance markets, due to the limited scope of the U.S. laws that tax insurance income derived by U.S.-controlled foreign companies. The Committee, accordingly, is proposing an additional reservation to the treaty to overcome this problem. Specifically, this reservation limits the waiver by the United States of its insurance excise tax to two cases.

The first case includes insurance premiums that constitute income of a Bermudian insurance enterprise that is a controlled foreign corporation in a taxable year under section 957(a) or (b) of the Internal Revenue Code as in effect for such taxable year. The second case includes insurance premiums that constitute income of a Bermudian insurance enterprise in a taxable year in which the company is (i) subject to the rules of section 953(c) of the Internal Revenue Code of 1986, and (ii) a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code of 1986, as modified by section 953(c)(1) of such Code, but only if the premiums constitute related person insurance income within the meaning of section 953(c) of the Internal Revenue Code of 1986.

Waiving the U.S. insurance excise taxes with respect to any other premiums earned by Bermuda insurance companies would allow income earned from the insurance of U.S. risks to escape all current U.S. tax by virtue of Code and treaty rules. Furthermore, since Bermuda now imposes no income tax, this income would not incur any Bermuda tax.

The Committee believes that as a matter of public policy, tax treaties should not place any U.S. industry at a competitive disadvantage with foreign competitors, particularly in U.S. markets. The Committee does not believe that those provisions of the U.S. tax laws imposing an excise tax on insurance and reinsurance premiums paid to foreign insurance companies should be waived without prior consultations with the appropriate Committees of Congress by Treasury in future tax treaty negotiations.

***Mutual assistance provisions***

The proposed treaty, supplemented by notes exchanged when the treaty was signed, provides for mutual assistance in tax matters, including the exchange of information. The Committee anticipates that information exchanged under the treaty will be of significant benefit to U.S. tax authorities in their efforts to enforce U.S. tax laws. In the past, Bermuda's bank secrecy laws, for example, have sometimes proved an obstacle to enforcement efforts in cases involving U.S. persons with dealings in Bermuda.

Nearly all recent U.S. income tax treaties provide for the exchange of information by the United States and the treaty partner. Most of these exchange of information provisions follow fairly closely that contained in the 1981 U.S. model income tax treaty.

While departures from the U.S. model provision are contemplated by the Treasury Department in certain circumstances, the model provision is nonetheless a standard against which to compare the proposed treaty's exchange of information rules. The Treasury Department has also published (in 1984) a discussion draft (the "CBI discussion draft") of an exchange of information agreement which the Department believes satisfies the statutory requirements of the Caribbean Basin Economic Recovery Act (the "CBI legislation"). Under the CBI legislation, Bermuda and certain Caribbean countries that enter into a qualified exchange of information agreement with the United States will be eligible for special convention tax benefits (Internal Revenue Code sec. 274(h)(6)). Persons will be able to deduct expenses incurred in attending conventions in a country entering into a qualified agreement as if the convention had been held in the United States. To date, CBI exchange of information agreements have become effective in Barbados, Dominica, Grenada, and Jamaica.

The exchange of information requirements of the CBI legislation are relevant in measuring the adequacy of the treaty's exchange of information rules because, in the diplomatic notes accompanying the treaty, the U.S. Government indicates that it will extend to Bermuda the special convention deduction benefits provided for in the CBI legislation on the basis of an executive agreement incorporating the treaty's exchange of information rules.

According to the Treasury Department, the treaty's mutual assistance provisions fully satisfy the statutory requirements for exchange of information agreements set forth in the CBI legislation. In general, the Committee believes that the treaty's mutual assistance provisions comply with the CBI requirements. The Committee is concerned because the treaty's exchange of information provisions are less detailed than those of the U.S. model, the CBI discussion draft, and the CBI exchange of information agreement with Barbados. For example, with respect to fiscal laws other than those relating to tax fraud and tax evasion, the treaty itself states that the competent authorities of the two countries shall, through consultations, develop appropriate conditions, methods, and techniques for providing, and shall thereafter provide assistance as appropriate in carrying out those laws. The notes add some specific requirements drawn from the U.S. model and CBI discussion draft, but the references to consultations and the development of appropriate methods contrast with the detailed and, in many cases, self-executing information exchange requirements contained in the discussion draft and the CBI exchange of information agreement with Barbados.

On the other hand, the Treasury Department has indicated that the references to consultations and the development of appropriate techniques are not meant to imply any substantive restrictions on the scope of the information obligation. These references are drawn from the United Nations model income tax treaty and are merely aimed at enabling the United States and Bermuda to work out the modalities for exchange of information between them. Also, it should be noted that the Treasury Department states in its technical explanation of the CBI discussion draft that a final agreement

need not contain all of its provisions to be acceptable to the United States.

The CBI legislation provides that an exchange of information agreement may not be limited to information concerning nationals or residents of the United States or the beneficiary country. However, the notes amplifying the proposed treaty state that, in connection with mutual assistance relating to persons not resident in the United States or Bermuda, it must be established to the satisfaction of the competent authority of the requested jurisdiction that such assistance is necessary for the proper administration and enforcement of the fiscal laws of the requesting jurisdiction; where such necessity has been duly established, the competent authorities shall consult as to the appropriate form of such assistance. The notes might be read to limit the assistance that Bermuda will provide the United States in connection with a tax matter involving a U.S. citizen residing outside the United States and Bermuda. On the other hand, the Committee is informed that representatives of the Government of Bermuda recently confirmed with the Treasury Department the understanding of the U.S. negotiators that the notes are not to be read so as to limit the assistance that Bermuda will provide the United States with respect to U.S. citizens resident outside of the United States and Bermuda.

The Committee also took note of the limitation on the scope of the treaty's exchange of information provisions. The treaty's exchange of information provisions do not apply in limited cases to confidential information or documents derived or created before the treaty's entry into force. (See discussion of exchange of notes below.) By contrast, the CBI legislation does not explicitly address the issue of the retroactive effect of CBI information exchange agreements though its exchange of information rules are not limited by their terms to open taxable years beginning after an agreement enters into force or information derived after an agreement enters into force.

The Treasury Department believes that the CBI legislation gives it discretion in negotiating qualifying exchange of information agreements to agree to such effective date provisions as will reasonably carry out Congressional intent in prescribing standards for such agreements. In Treasury's view, the effective date limitations in the treaty (and the notes) relating to Bermudian confidentiality laws are consistent with that discretion. These limited restrictions on the ability to obtain confidential information from Bermuda were agreed to in recognition of Bermuda's historical official government position that it would not exchange tax information with other countries.

The CBI legislation also requires, with one exception, that an exchange of information agreement provide for the exchange of such information as may be necessary or appropriate to carry out and enforce the tax laws of the United States and the beneficiary country, including information which may otherwise be subject to nondisclosure provisions of the local law of the beneficiary country such as provisions respecting bank secrecy and bearer shares. The exception applies to information protected by local bank secrecy or bearer share law, if such information is sought solely for civil tax purposes. The exception is available only if the Secretary of the

Treasury, after making all reasonable efforts to negotiate an agreement which includes the exchange of such information, determines that such an agreement cannot be negotiated, but that the agreement which was negotiated will significantly assist in the administration and enforcement of the U.S. tax laws, and if the President determines that the agreement as negotiated is in the national security interest of the United States.

By contrast, the notes provide that Bermuda's obligation under the proposed treaty to provide assistance with respect to tax matters will be limited only by the confidentiality restrictions of Bermudian law relating to the solicitor-client privilege. The Committee is informed by the Treasury Department that this limitation is implicit in the U.S. model treaty, the CBI discussion draft, and most recent U.S. tax treaties, which generally state that a country will not be obligated by information exchange rules to carry out administrative measures at variance with its laws and administrative practice. The Committee believes that it is generally appropriate for treaty exchange of information rules to respect the solicitor-client privilege (or, in the case of the United States, the attorney-client privilege).

Notwithstanding the issues relating to the treaty's exchange of information provisions just discussed, the Committee believes that those provisions, in general, will prove highly valuable to U.S. tax authorities.

***Anti-treaty shopping provision***

The proposed treaty contains a provision that limits the use of the treaty by third-country residents. When a resident of a third country can use a treaty between the United States and a treaty partner to reduce his tax liability to the United States, that resident can obtain a reduction in U.S. tax without reciprocal benefits accruing to U.S. residents earning income in that third country. Unintended use of treaties can erode the U.S. tax base. This unintended use of treaties by third-country residents is referred to as "treaty shopping."

The provisions of the proposed treaty with Bermuda that are intended to prevent treaty shopping differ from the anti-treaty shopping provisions of the U.S. model treaty in some respects. While the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses, the model provision is nonetheless a standard against which to compare the proposed treaty's anti-treaty shopping provision.

One provision of the anti-treaty shopping article of the proposed treaty is less restrictive than the comparable rule in the 1981 U.S. model and some recent U.S. treaties. The U.S. model allows benefits to be denied unless more than 75 percent of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like some newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50 percent, and broadens the class of qualifying shareholders to include residents of either treaty country and U.S. citizens. Thus, this safe harbor is considerably easier to enter under the proposed treaty. The treaties with Aus-

tralia and New Zealand, ratified in 1983, and Cyprus, ratified in 1985, maintain the U.S. model's 75-percent standard, but like the proposed treaty, they expand the class of qualified shareholders to include certain U.S. persons.

The inclusion of U.S. residents and citizens as qualifying shareholders will allow U.S. owners of some Bermuda-based insurers to operate such insurers free of the insurance excise tax. The Committee is concerned that this could encourage additional movement of U.S. insurance activity offshore (see discussion of this issue above). A similar provision in the Barbados treaty, coupled with that treaty's exemption from tax for certain insurers, has already contributed to a favorable tax climate offshore for insuring U.S. risks.

Nonetheless, the proposed treaty has generated concern by the Committee regarding the treatment of U.S. residents and citizens as qualifying shareholders for purposes of the anti-treaty shopping rules. This treatment may permit U.S. owners of Bermuda-based insurers to be the primary beneficiaries of the proposed treaty's provisions that waive the U.S. insurance excise tax. While anti-treaty shopping provisions are generally aimed at preventing abuse of treaties by third-country residents, the Committee questions whether they should facilitate the indirect reduction of U.S. taxes for U.S. persons. The Committee believes that this extension of treaty benefits to U.S.-owned foreign corporations in future treaty negotiations should be consistent with sound tax policy goals and should not be made as a matter of course.

In addition to the ownership requirement, the proposed treaty includes, as do the U.S. model and most recent treaties, a "base erosion" provision which denies benefits under the treaty if a substantial part of an entity's income is used to satisfy liabilities to persons who are neither residents of one of the two countries, nor U.S. citizens. Diplomatic notes signed with the proposed treaty state that the United States considers the term "substantial" for this purpose to be 50 percent or, in certain cases, a lesser amount. In defining liabilities for purposes of determining whether a substantial part of a company's income is used to meet liabilities to non-U.S. and non-Bermuda residents, the proposed treaty excludes from liabilities interest or other expenses paid on insurance obligations. The base erosion provision by itself does not cause the Committee much concern. However, when viewed in conjunction with the more than 50-percent ownership requirement, it does cause the Committee to urge that the Treasury Department evaluate whether the anti-treaty shopping provision of the proposed treaty is strong enough to prevent third-country residents from claiming benefits under the treaty or whether additional provisions may need to be negotiated in the future.

***Precedent***

Even though the Committee recommends that the Senate give its advice and consent to ratification, subject to the two reservations described above, the Committee does not believe that this treaty, even with the reservations, should serve as a precedent for future U.S. tax treaty negotiations. The Committee's willingness to recommend consent stems from the unique circumstances, involving important national security interests, surrounding this treaty. In view

of the existing treaty with Barbados, these interests would be unduly harmed by the failure to ratify.

When viewed apart from these unique circumstances, however, the treaty raises tax policy issues that cause the Committee concern. In particular, the Committee questions the wisdom of entering into a tax treaty that reduces U.S. tax with a country which has no direct taxes, when the justification for granting such tax reductions traditionally has been the avoidance of international double taxation. In the context of this treaty, provisions that may be suitable in other treaties with legitimate taxing countries could cause undesirable results. For example, the absence of any Bermudian direct taxes, coupled with a treaty-shopping provision allowing Bermudian companies owned by U.S. persons to benefit from the treaty, may render U.S. persons the main beneficiaries of the treaty's principal U.S. tax reduction—the waiver of the insurance excise tax. And although the treaty shopping provisions of the treaty appear only slightly less restrictive vis-a-vis third-country residents than similar provisions included in several treaties recently ratified, the treaty may nevertheless provide new tax avoidance opportunities for third-country residents.

## VII. BUDGET IMPACT

The Committee has been informed by the Staff of the Joint Committee on Taxation that the proposed treaty is estimated to reduce budget receipts by $178 million in fiscal year 1989 and by $24 million in fiscal year 1990.

The Office of Management and Budget has provided the Committee with the following explanation of the budget treatment of this treaty under the Balanced Budget and Emergency Deficit Control Act of 1985, as amended:

EXECUTIVE OFFICE OF THE PRESIDENT,
OFFICE OF MANAGEMENT AND BUDGET,
*Washington, DC.*

Hon. CLAIBORNE PELL,
*Chairman, Committee on Foreign Relations,*
*U.S. Senate, Washington, DC.*

DEAR MR. CHAIRMAN: I understand there may be some question concerning the budgetary treatment of the Bermuda Tax Convention Treaty under Gramm-Rudman-Hollings (G-R-H), the Balanced Budget and Emergency Deficit Control Act of 1985, as amended.

I am advised by counsel that, under G-R-H, the 1989 fiscal impact of ratification of the treaty by the Senate may not be taken into consideration for purposes of the October 15, final sequester report. Section 251(c) of G-R-H provides that the final sequester report due October 15 may only be adjusted for "laws enacted and regulations promulgated as final" after the August 15 initial report snapshot date. Ratification of a treaty is not "enactment" of a law, and, accordingly, the effects of such ratification may not be counted for purposes of the final sequester report.

Sincerely yours,

JAMES C. MILLER III,
*Director.*

Identical letter sent to Hon. Jesse Helms.

## VIII. EXPLANATION OF TREATY PROVISIONS

Set forth below is a detailed, article-by-article explanation of the proposed tax treaty between the United States and the Government of the United Kingdom on behalf of the Government of Bermuda, followed by an explanation of the notes exchanged when the proposed treaty was signed.

### Article 1. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty. Others are not because of the treaty's limited scope. The treaty also contains some definitions not found in most U.S. income tax treaties relating to insurance income.

The term "person" is defined to include an individual, an estate or trust, a company, a partnership, and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes.

An "enterprise of insurance" means an enterprise of which the predominant business activity during the taxable year is the issuing of insurance or annuity contracts or acting as the reinsurer of risks underwritten by insurance companies, together with the investing or reinvesting of assets held in respect of insurance reserves, capital, and surplus incident to the carrying on of the insurance business.

An enterprise of a country is defined as an enterprise carried on by a resident of that country.

An "insurance obligation" generally is defined as any obligation which, in accordance with normal industry practice, an insurer undertakes under the terms of a contract of insurance, to make payments or incur expenses in connection with the insurance protection offered under the contract, including any such obligation to pay claims to or for the benefit of the insured resulting from damages connected with the covered risk, to pay interest on such claims, and to pay the costs of defending an insured against such damages. In no event, however, does an insurance obligation include any obligation to pay premiums or other costs of reinsuring a covered risk.

The U.S. competent authority is the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International).

The Bermuda competent authority is the Minister of Finance or his delegate.

The "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any

other U.S. possession or territory. The term "Bermuda" means the islands in the Atlantic Ocean known as Bermuda.

The term "Covered Jurisdiction" means the United States or Bermuda, as the context requires.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms are to have the meaning which they have under the applicable laws (tax laws, in the case of the United States) of the country applying the treaty.

**Article 2. Residence**

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the countries, as that term is defined in the treaty.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his worldwide income, while a nonresident alien is taxed only on his U.S. source income and on his income that is effectively connected with a U.S. trade or business. Under the standards for determining residence provided in the Tax Reform Act of 1984, an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes also is a U.S. resident. A company is a resident of the United States if it is organized in the United States.

In the case of the United States, the proposed treaty defines "resident of a Covered Jurisdiction" to mean a company created under the laws of the United States or a political subdivision of the United States. In the case of the United States, the term also means any person (other than a company) resident in the United States for purposes of U.S. tax. According to the Treasury Department's technical explanation of the proposed treaty, this includes a resident alien individual, who is subject to tax by the United States on his worldwide income, or an alien present in the United States who makes an election under Internal Revenue Code section 6013(g) or (h), as well as a resident U.S. citizen. However, a partnership, estate, or trust is considered to be a resident of the United States only to the extent that the income it derives is subject to U.S. tax, either in its hands or in the hands of its partners or beneficiaries.

In the case of Bermuda, the proposed treaty generally defines "resident of a Covered Jurisdiction" to mean a company, partnership, trust, or association created under Bermuda law and an individual who has the status of a legal resident of Bermuda.

Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not entitled to the benefits of the treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the 1981 proposed U.S. model income tax treaty ("U.S. model treaty"), but the U.S. model result has been achieved in very few treaties.

Unlike the U.S. model treaty and most recent U.S. tax treaties, the proposed treaty does not provide "tie-breaker" or other rules for determining residence for treaty purposes in the case of dual

resident individuals, partnerships, trusts, or estates. The proposed treaty definitions of a U.S. resident company and a Bermuda resident company appear to preclude the possibility of a dual resident company under the proposed treaty.

**Article 3. Permanent Establishment**

The proposed treaty contains a definition of the term "permanent establishment" that, with certain exceptions, follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model treaty"). Certain aspects of the definition are modeled after the permanent establishment definition of the model treaty developed by the United Nations for use between developed and developing countries ("United Nations model treaty"). Also, the definition refers only to permanent establishments through which the business of insurance enterprises is carried on, reflecting the treaty's limited scope.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit source country taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether dividends, interest, and royalties will be taxed as business profits. U.S. taxation of business profits is discussed under Article 4.

The principal areas where the proposed treaty departs from the U.S. model are the treaty's inclusion in the permanent establishment definition of a sales outlet and an individual performing services for more than 90 days. These departures from the U.S. model have been reflected in other recent U.S. income tax treaties with developing countries, such as the treaties with Jamaica and Barbados.

In general, under the proposed treaty, a permanent establishment is a regular place of business in one country through which the business of an insurance enterprise of the other country is wholly or partly carried on. The U.S. model treaty refers to a "fixed" rather than "regular" place of business but, according to the Treasury Department's technical explanation of the proposed treaty, no difference in meaning was intended. Under the proposed treaty (as under the U.S. model), a permanent establishment includes especially a place of management; a branch; an office; and (as an addition not found in the U.S. model) a premises used as a sales outlet.

An enterprise of insurance will also have a permanent establishment if it furnishes services, including consultancy, management, technical, or supervisory services in a country through employees or other personnel, but only if these continue within that country for more than 90 days in any twelve-month period. No permanent establishment will result, however, in any taxable year in which these services are performed less than 30 days. However, the 90-day minimum requirement does not apply, and a permanent establishment will result, if the services are performed for an associated enterprise. This services provision is similar to the six-month serv-

ices rule of the United Nations model treaty. It is not found in the U.S. model treaty but has been included, in some form, in some recent U.S. income tax treaties with developing countries (e.g., Jamaica, the Philippines, and Barbados). Two enterprises are "associated" if either participates directly or indirectly in the management, control, or capital of the other, or if the same persons participate directly or indirectly in the management, control, or capital of both.

The general permanent establishment rule is modified to provide that a regular place of business of an insurance enterprise that is used solely for any of several specified activities will not constitute a permanent establishment. These activities include the purchase of goods or merchandise, the collection or provision of information, advertising, scientific research, and similar preparatory or auxiliary activities for the insurance enterprise.

Even if an insurance enterprise of one country does not have a permanent establishment in the other country under the foregoing rules, it will be treated as having one if it maintains an agent in the other country who has, and habitually exercises, the authority to enter into contracts in that other country in the name of the enterprise, with respect to the activities which the agent undertakes on its behalf. This rule does not apply where the contracting authority is limited to those activities (described above), such as the purchase of goods or merchandise, that are excepted from the definition of permanent establishment.

The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business. However, the proposed treaty adds the limitation (similar to one found in the United Nations model treaty and some recent U.S. treaties) that, when the activities of the agent are devoted substantially on behalf of that enterprise, he will not be considered an agent of independent status if the transactions between the agent and the enterprise were not made under arm's length conditions.

The determination whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a company that is a resident of the other country or to a company that engages in business in that other country. Any such relationship is thus not relevant; only the activities of the company being tested are relevant.

**Article 4. Taxation of Insurance Enterprises**

***Business profits***

*U.S. Code rules*

U.S. law distinguishes between the business income and the investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a U.S. trade or business. The regular individual or corporate rates

apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is U.S. or foreign source. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of a trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income of a foreign person engaged in a trade or business in the United States is treated as effectively connected income.

Some foreign source income is effectively connected income if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. For example, three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the United States (or received by a corporation in the business of trading stocks or securities for its own account); and certain sales income attributable to a U.S. sales office. In addition, in the case of a foreign insurance company, any foreign source income which is attributable to its U.S. business is treated as effectively connected.

Trading in stocks, securities, or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. Thus, income from trading through a U.S.-based employee, a resident broker, commission agent, custodian, or other agent, or from trading by a foreign person physically present in the United States is not generally taxed as business income. However, this rule does not apply to dealers or to corporations the principal business of which is trading in stocks or securities for their own account.

*Proposed treaty rules*

Under the proposed treaty, business profits of an insurance enterprise of one country which are derived from carrying on the business of insurance (including insubstantial amounts of income incidental to such business) are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on or has carried on business. This is the basic limitation under the treaty on the United States' right to tax income of a Bermuda resident insurer. The proposed treaty's rules on business profits generally follow the provisions of the U.S. model treaty, except as noted below. Also, they apply to insurance enterprises only.

The taxation of business profits of an insurance enterprise under the proposed treaty differs from internal U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits (that is, requiring a permanent establishment), and by substitut-

ing an "attributable to" standard for the Code's "effectively connected with" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States and that the profits be effectively connected therewith. Under the proposed treaty, on the other hand, a certain type of fixed place of business must be present and the business profits of the insurer must be attributable to that fixed place of business.

Unlike many U.S. treaties and the U.S. model treaty, the proposed treaty does not define the term "business profits." To the extent not dealt with in other articles, the term will be defined either under the law of the country applying the treaty or by mutual agreement of the two countries.

The business profits of a permanent establishment of an insurance enterprise are determined on an arm's-length basis. Thus, there is to be attributed to a permanent establishment the business profits that would reasonably be expected to have been derived by it if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions. For example, this arm's-length rule applies to transactions between a permanent establishment and an office of the resident enterprise located in a third country. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions generally are allowed for expenses, wherever incurred, that are incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the enterprise as a whole (or the part thereof which includes the permanent establishment). Thus, for example, a Bermuda insurer which has a branch office in the United States but which has its head office in Bermuda will, in computing the U.S. tax liability of the branch, be entitled to deduct the executive, general administrative, and other expenses incurred in Bermuda by the head office that are reasonably connected with the profits of the U.S. branch.

Business profits to be attributed to a permanent establishment are to be determined by the same method year-by-year unless there is good and sufficient reason to the contrary. In the United States, "good and sufficient reason" may be a change of accounting method requiring IRS approval, the Treasury Department's technical explanation states.

The treaty does not affect taxation by a country of dividends, interest, royalties, gains or compensation for services beneficially owned by a resident of the other country if those items of income are not attributable to a permanent establishment of the beneficial owner of the income in the first-mentioned country. Thus, for example, under the proposed treaty, dividends, royalties, and certain interest received by a Bermuda resident from U.S. sources generally will remain subject to the United States' 30-percent withholding tax on U.S. source income where those items are not effectively connected with a U.S. trade or business.

***Saving clause***

The proposed treaty includes a "saving clause". Under this clause, the United States reserves the right to tax its citizens, notwithstanding any provision of the treaty. By reason of the saving clause, the United States will continue to tax its citizens who are residents of Bermuda as if the treaty were not in force. Under the saving clause, the United States also reserves the right to tax its residents who are not U.S. citizens as if the treaty were not in force. For purposes of the treaty (and, thus, for purposes of the saving clause), "residents" include corporations and other entities as well as individuals (Article 2).

***Limitation on benefits***

The proposed treaty contains a provision that is intended to limit the benefits of this article to persons who are entitled to them by reason of their residence in the United States or Bermuda.

At times, residents of third countries attempt to use a treaty. This use is known as "treaty shopping." In certain circumstances, and without appropriate safeguards, the nonresident is able to secure treaty benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed treaty contains provisions intended to limit the use of the treaty to bona fide residents of the two countries. This is accomplished by providing that a person (for example, a corporation, partnership, trust, or other business organization) is not entitled to the benefits of this article unless it satisfies an ownership test and a base erosion test, or a public company test.

Under the ownership test, more than 50 percent of the beneficial ownership of an entity must be owned directly or indirectly by any combination of one or more individual residents of Bermuda or the United States, or U.S. citizens. In the diplomatic notes accompanying the treaty, the U.S. Government indicates that it will not treat any individual as owning indirectly through an intermediate entity any beneficial interest in an entity resident in one of the two countries if the evidence of and rights to the ownership of any interest in the intermediary entity are in bearer form.

The base erosion test requires, in addition, that the income of an entity not be used in substantial part, directly or indirectly, to make distributions (where those distributions are made with respect to beneficial ownership interests and are substantially disproportionate to such interests) to, or to meet liabilities (including liabilities for interest, royalties, or other expenses, but not including liabilities, whether or not for interest or other expenses, which constitute insurance obligations) to, persons who are neither Bermuda residents, U.S. residents, nor U.S. citizens. The notes accompanying

the treaty state that the term "liabilities," for this purpose, refers to payments which reduce gross premiums or are deductible against gross income, and includes interest, royalties, and premiums paid in connection with reinsuring risks. Also, the notes state, if the sum of (1) the ratio which reinsurance premium payments bear to gross premiums less return premiums and (2) the ratio which payments of other liabilities bear to (a) gross premiums less return premiums and less reinsurance premiums payments plus (b) gross income from all other activities, is not more than 50 percent, such payments will not generally be considered "substantial," provided that in appropriate circumstances a lower aggregate percentage will be considered "substantial."

The ownership and base erosion tests would, for example, deny the treaty reduction of the U.S. insurance excise tax on premiums paid to a company that is owned by individual residents of a third country or that pays out most of its gross income as interest on debt (other than on insurance obligations) owed to individual residents of a third country.

Under the public company test, a company that is a resident of Bermuda or the United States and that has substantial and regular trading in its principal class of stock on a recognized stock exchange is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of interest payments it makes. The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; and any other stock exchange agreed upon by the competent authorities of the two countries.

The proposed treaty does not contain either of the typical provisions found in the U.S. model and several recent U.S. treaties, which allow treaty benefits to an entity resident in the United States or the treaty partner, the ownership, base erosion, and public company tests notwithstanding, if (in the case of the model and several U.S. treaties) it is determined that the acquisition and maintenance of the entity, and the conduct of its operations did not have as one of its principal purposes the obtaining of such treaty benefits, or if (in the case of the more recent treaties) it is determined that the resident entity's income is derived in connection with, or is incidental to, the active conduct of a trade or business in the residence country.

The proposed treaty contains a rule not found in the U.S. model or in most recent U.S. income tax treaties that requires consultation between the competent authorities if a country proposes to deny benefits to a resident of the other country under the anti-treaty shopping provisions and that other country requests such consultation. According to the Treasury Department's technical explanation of the treaty, this rule does not require prior agreement of the competent authorities before treaty benefits may be denied. The Committee agrees with the Treasury Department on this point, and recommends Senate consent to ratification of the treaty on that basis.

***Associated enterprises***

The proposed treaty states that none of its provisions will limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between non-independent persons, when such allocation is necessary to prevent evasion of taxes or clearly to reflect the income of those persons. Thus, the proposed treaty makes it clear that the United States retains the right to apply its inter-company pricing rules (Code sec. 482) and its rules relating to the allocation of deductions (e.g., Code secs. 861, 862, and Treas. Reg. secs. 1.861–8 and 1.882–5). "Non-independent persons," for this purpose, are those (whether or not residents of the United States or Bermuda) owned or controlled, directly or indirectly, by the same interests.

Unlike most other U.S. tax treaties, the proposed treaty does not contain a separate arm's-length pricing provision.

***Taxes covered***

This article applies to all Federal income taxes imposed under the Internal Revenue Code, except the personal holding company tax and the accumulated earnings tax. The treaty also applies to the U.S. excise taxes imposed on insurance and reinsurance premiums paid to foreign insurers. The excise taxes imposed on insurance and reinsurance premiums paid to foreign insurers are covered by the treaty only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to benefits under this or another U.S. tax treaty that applies to these excise taxes. Therefore, generally income of a Bermuda insurer from the insurance of U.S. risks will not be subject to the insurance excise tax (except in situations where the risk is reinsured with a company not entitled to the exception and in situations where the reservations require imposition of the tax) if that insurance income is not attributable to a U.S. permanent establishment maintained by the Bermuda insurer. Some recent U.S. income tax treaties, for example, the treaties with France, Hungary, and Barbados, also cover the insurance excise tax. It is a covered tax under the U.S. model treaty.

The insurance excise tax will continue to apply notwithstanding the proposed treaty in situations where a Bermuda insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with another foreign insurer who is neither a resident of Bermuda nor a resident of a third country with a U.S. tax treaty which entitles the foreign insurer to exemption from the excise tax. For example, assume that a Bermuda company not engaged in a U.S. trade or business insures a U.S. casualty risk and receives a premium of $200. The company reinsures part of the risk with a German insurance company (not currently entitled to exemption from the excise tax) and pays that German company a premium of $100. The four-percent excise tax on casualty insurance applies to the premium paid to the Bermuda insurance company to the extent of the $100 reinsurance premium. Thus, the U.S. insured is liable for an excise tax of $4, which is four percent of the portion of its premium to the Bermuda insurer which was used by the Bermuda insurer to reinsure the risk.

This article will also apply to any identical or substantially similar taxes which are imposed by the United States after the date of signature of the treaty in addition to, or in place of, the existing taxes. In addition, it will apply to any tax imposed by Bermuda after the date of signature of the treaty which is identical or substantially similar to the existing U.S. taxes to which the article applies, to the same extent as it applies to those existing taxes.

The proposed treaty, like the U.S. model, obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in the tax laws of its country and of any official published material concerning the application of the treaty, including explanations, regulations, rulings, or judicial decisions.

***Nondiscrimination***

The proposed treaty contains a limited nondiscrimination provision. Under the proposed treaty, neither country may tax a permanent establishment of an insurance enterprise resident in the other country less favorably than it taxes its own resident insurance enterprises carrying on the same activities. Consistent with the U.S. and OECD models, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. Also, the treaty states that this provision will not prevent the United States from imposing an additional tax on the income of a permanent establishment maintained in the United States by a Bermuda resident. The Treasury Department's technical explanation of the proposed treaty confirms that such an additional tax would include the branch profits tax. The Tax Reform Act of 1986 introduced a branch profits tax.

The proposed treaty also generally provides that expenses paid by a resident of one country to an insurance enterprise resident in the other must be deductible as if paid to an insurance enterprise resident in the country of the payor.

The treaty's nondiscrimination rules, unlike those of the U.S. model and many recent U.S. income tax treaties, are limited in their application to those taxes generally covered by the treaty (*see* "Taxes covered" above).

The treaty does not include several nondiscrimination rules found in the U.S. model treaty and most recent U.S. income tax treaties. For example, it omits the provision prohibiting treaty partners from discriminating by imposing other or more burdensome taxes (or other requirements connected with taxes) on nationals of the other country resident in the host country than they impose on their own nationals who are in the same circumstances. It also does not contain the rule that enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one of more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement that is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

**Article 5. Mutual Assistance in Tax Matters**

The proposed treaty requires the competent authorities of the countries to provide assistance as appropriate in carrying out the laws of the respective countries relating to the prevention of tax fraud and the evasion of taxes. In addition, it requires the competent authorities, through consultations, to develop appropriate conditions, methods, and techniques for providing, and thereafter to provide, assistance as appropriate in carrying out the fiscal laws of the respective countries other than those relating to tax fraud and the evasion of taxes. The diplomatic notes accompanying the treaty elaborate on the requirements of this article. The notes are discussed below.

This article, as augmented by the notes, forms the basis for cooperation between the two countries in their attempts to deal with avoidance or evasion of taxes and to obtain information so that they can properly administer their fiscal laws.

The Internal Revenue Code, as amended by the Caribbean Basin Economic Recovery Act, conditions the eligibility of Bermuda and certain Caribbean countries for special convention tax benefits on the country's entry into an exchange of information agreement with the United States satisfying the requirements set forth in that Act. Deductions are permitted for expenses of attending conventions in qualifying countries to the same extent they would be permitted if such conventions had been held in the United States. In the notes, the U.S. Government states that, upon entry into force of the treaty, the Secretary of the Treasury, or his delegate, will be prepared to execute on behalf of the U.S. Government an executive agreement satisfying the requirements of the Caribbean Basin Economic Recovery Act which would incorporate by cross-reference the treaty's and notes' mutual assistance and confidentiality (Article 6) provisions, and would allow persons incurring expenses for attending business conventions in Bermuda to claim deductions for such expenses as though Bermuda were included as part of the North American area.

**Article 6. Confidentiality**

The treaty limits the use of information disclosed under its mutual assistance provisions (Article 5). The limitations are similar to those contained in the U.S. model treaty and CBI discussion draft.

The treaty provides that any matters subject to assistance under the mutual assistance article are to be treated as confidential. Such matters or items may be disclosed, in the case of the United States, only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. Such matters or items may be disclosed, in the case of Bermuda, only to the competent authority of Bermuda.

Such persons or authorities can use the disclosed matters or items only for purposes of the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes. They may disclose the in-

formation in public court proceedings or in public decisions. In the case of the United States, persons involved in the administration of taxes include legislative bodies involved in oversight of the administration of taxes, including their agents such as, for example, the U.S. General Accounting Office, with respect to such information as they consider necessary to carry out their oversight responsibilities. The proposed treaty specifies that information will not be disclosed to a third jurisdiction for any purpose. The Treasury Department informed the Committee that, during the treaty negotiations, Bermuda stated that it would not consent under any circumstances to the disclosure to third countries of information provided by it to the United States. The foregoing rule acknowledges Bermuda's position. The rule is consistent, the Treasury Department says, with its policy of not disclosing information to third jurisdictions without the consent of the treaty partner that furnished the information.

**Article 7. Entry into Force and Termination**

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country. The treaty states that instruments of ratification are to be exchanged as soon as possible. However, in the notes amplifying the treaty, the United States observed that, under Bermuda's legal system, the treaty is not self-executing and that legislation would be required to implement the treaty. Bermuda expressed the understanding that instruments of ratification would not be exchanged until such legislation as may be required to implement the treaty had been enacted.

The treaty is to enter into force upon the exchange of instruments of ratification and its provisions are to take effect as follows: With respect to the U.S. excise taxes on insurance premiums paid to foreign insurers, the treaty applies retroactively to premiums paid or credited on or after January 1, 1986. With respect to income taxes imposed on the business profits of an insurance enterprise, the treaty applies to profits derived in taxable years beginning on or after the first day of the calendar year in which the treaty enters into force.

The provision governing mutual assistance in the prevention of tax fraud and tax evasion generally applies to taxable years not barred by the statute of limitations of the country requesting assistance. However, neither country is required to provide assistance with respect to taxable years beginning prior to January 1, 1977. The provision governing mutual assistance in carrying out the fiscal laws of the two countries other than those relating to tax fraud and tax evasion also generally applies to taxable years not barred by the statute of limitations of the country requesting assistance. However, neither country is required to provide assistance under this provision with respect to taxable years beginning prior to the entry into force of the treaty if such assistance would result in the breach of an obligation to maintain confidentiality of information under the laws of the country to which the request is made on the date of signature of the treaty. Neither country is required to provide assistance under this provision in any circumstances with respect to taxable years beginning prior to January 1, 1977. The diplomatic notes accompanying the treaty (discussed below)

elaborate further on when the mutual assistance provision relating to fiscal laws other than those relating to tax fraud and tax evasion becomes effective.

The proposed treaty will continue in force indefinitely, but either country may give notice of termination to the other country on or after June 30th of the year following the calendar year in which the treaty enters into force. If such notice of termination is given, the treaty will terminate on the first day of the seventh full calendar month following the month in which the notice is given.

## IX. EXPLANATION OF DIPLOMATIC NOTES

At the signing of the proposed treaty, notes were exchanged. These notes confirm understandings reached between representatives of the United States and Bermuda in the course of discussions involving the proposed treaty. Set forth below is a description of the understandings stated in the notes.

**Paragraph 1. (Relief from insurance excise tax)**

The U.S. Government noted that, in order to implement the relief from the U.S. insurance excise taxes provided by the treaty, it would be necessary to establish procedures which would, among other things, ensure that companies claiming that relief are entitled to it and, in the case of refunds, that the amount and recipient of the refunds are properly determined. Representatives of Bermuda assured the representatives of the U.S. Government of Bermuda's willingness to establish such procedures as may be mutually agreed to ensure that relief from the insurance excise tax is obtained by appropriate persons.

**Paragraph 2. (Limitation on benefits)**

The U.S. Government noted that the proposed treaty (paragraph 3 of Article 4) limits the availability of the treaty benefits otherwise granted to insurance enterprises by either country to persons resident in the other country which are more than 50 percent owned, directly or indirectly, by individual residents of the two countries or U.S. citizens and which do not use their income in substantial part, directly or indirectly, to make certain payments to persons who are neither residents of the countries nor U.S. citizens. The U.S. Government indicated that, for purposes of the ownership test, it would not treat any individual as owning "indirectly" through an intermediary entity any beneficial interest in an entity resident in one of the two countries if the evidence of and rights to the ownership of any interest in that intermediary entity are in bearer form. This treatment applies whatever the residence of the intermediary entity. For purposes of the second test, the base erosion test, the term "liabilities" refers to payments which reduce gross premiums or are deductible against gross income, and includes interest, royalties, and premiums paid in connection with reinsuring risks. Also, if the sum of (1) the ratio which reinsurance premium payments bear to gross premiums less return premiums and (2) the ratio which payments of other liabilities bear to (a) gross premiums less return premiums and less reinsurance premium payments plus (b) gross income from all other activities, is no more than 50 percent, such payments will not generally be considered "substantial," provided that in appropriate circumstances a lower aggregate percentage will be considered "substantial."

**Paragraphs 3–11. (Mutual assistance in tax matters)**

The U.S. Government expressed its concern that the obligations of the countries not be construed to establish an obligation to provide assistance with respect to matters other than those relating to the domestic tax laws of a country. The representatives of the United States and Bermuda agreed that the intended scope of the mutual assistance article (Article 5) is limited to assistance relating to the domestic tax laws of the countries.

Representatives of Bermuda expressed concerns as to the policies of the U.S. Government regarding assistance that might relate to persons not resident in one of the two countries and matters that do not constitute a criminal investigation. The representatives of the U.S. Government discussed with the representatives of Bermuda the United States' policies relating to information exchange. The representatives of the United States and Bermuda agreed that, where the United States requests assistance with respect to a matter which relates to a person not resident in one of the two countries or does not constitute a criminal or tax fraud investigation, a senior official designated by the Secretary of the Treasury will certify the request as being relevant to and necessary for the determination of the tax liability of a U.S. taxpayer, or the criminal tax liability of a person under U.S. laws. The representatives of the United States and Bermuda further agreed that, in connection with any assistance relating to persons not resident in one of the two countries, it will be established to the satisfaction of the competent authority of the requested country that that assistance is necessary for the proper administration and enforcement of the fiscal laws of the requesting country. Where that necessity has been duly established, the competent authorities will consult as to the appropriate form of such assistance.

The representatives of the United States and Bermuda further agreed that it is intended that the mutual assistance to be provided under the treaty come into effect as follows: In general, Bermuda's obligation to provide assistance with respect to civil and criminal tax matters relating to taxable years of a taxpayer beginning after the treaty's entry into force will not be limited by any confidentiality restrictions of Bermudian law, other than those relating to solicitor-client privilege.

The notes provide that, with respect to matters relating to taxable years of a taxpayer beginning before the treaty's entry into force (but beginning on or after January 1, 1977, and not barred by the statute of limitations), the treaty's entry-into-force provisions (Article 7) limit Bermuda's obligation to provide assistance with respect to civil tax matters (other than civil fraud) if the provision of assistance would entail breach of an obligation to maintain confidentiality of information under Bermuda law in effect on the date of signature of the treaty. Under this standard, the notes state, confidential information would only include information protected by Bermudian statutory and common law. It is understood, according to the notes, that, under Bermudian common law, confidential information would include information protected by the common law solicitor-client privilege and banker-client privilege. It was agreed that if a taxpayer claims that other categories of informa-

tion are protected under Bermudian common law, and if the United States so requests, Bermuda will have such a claim determined in the courts of Bermuda.

The notes further state that Bermuda's obligation to provide assistance with respect to criminal tax matters (and tax matters involving civil fraud) relating to taxable years of a taxpayer beginning before the entry into force of the treaty (but on or after January 1, 1977, and not barred by the statute of limitations) would be limited by only the confidentiality obligations of the solicitor-client privilege. Bermuda's obligation to provide assistance with respect to civil tax matters (other than civil fraud) relating to a taxpayer's taxable years beginning after the treaty's entry into force will not require it to cause any person to breach a legal obligation, properly asserted by that person under the laws of Bermuda as in effect on the date of the treaty's signature, to maintain confidentiality of documents or information, where the documents or information were created in or derived from periods prior to the date of entry into force. However, the foregoing limitation on Bermuda's obligation to provide assistance will not apply to documents or information created in or derived from a date preceding the treaty's entry into force that are relevant to a request relating to taxable years after the treaty's entry into force and are of a kind that have a continuing operational effect. For example, if assistance is requested with respect to a taxpayer's bank transactions occurring after the entry into force of the treaty and the signature card for the account in question was executed prior to the entry into force of the treaty, Bermuda's obligation to provide assistance with respect to such a signature card would not be affected by the confidentiality rules. Similarly, if a taxpayer's depreciation deduction for a year after the treaty's entry into force is under examination, Bermuda's obligation to provide assistance with respect to information about the purchase price of the property in question, if such property was acquired before the treaty's entry into force, would not be affected by any confidentiality restrictions of Bermudian law.

The representatives of the U.S. Government expressed concerns regarding whether assistance would be provided in a form which would permit its use in judicial or administrative proceedings. The representatives of the United States and Bermuda agreed that it was intended that, if specifically requested by a competent authority of one of the countries, the competent authority of the other country will provide information in the form of depositions of witnesses and authenticated copies of original documents (including books, papers, statements, records, accounts, and writings) to the same extent that such depositions and documents can be obtained under the laws and administrative practices of that other country.

Representatives of Bermuda also expressed concerns as to the scope for use of unilateral compulsory measures by one country to obtain documents, records, or other materials located in the territory of the other country, and within the scope of assistance under the treaty. In this context the representatives of the U.S. Government confirmed that, with respect to documents, records, or other materials in the custody of a resident of one of the countries and located in the territory of that country, it will be U.S. policy, where

practicable, to request assistance pursuant to the provisions of the treaty before using unilateral measures.

The representatives of the U.S. Government inquired whether shares of a company organized under Bermuda law could be issued in bearer form. The representatives of Bermuda informed the U.S. representatives that the Bermuda law did not permit the issuance of company shares to an unnamed person.

The U.S. representatives also agreed that matters that were the subject of assistance under the treaty but that are made public in accordance with the treaty would not be further subject to the confidentiality provision (Article 6) of the treaty.

The representatives of the U.S. Government observed that, under the legal system applicable in Bermuda, the treaty is not self-executing and that legislation would be required to implement the provisions of the treaty. The representatives of Bermuda understood that instruments of ratification would not be exchanged until such legislation as may be required to implement the provisions of the treaty was enacted. It was further understood that the treaty would be ratified and other necessary steps, such as the adoption of implementing legislation necessary to meet the obligations of the treaty, would be taken so as to permit the exchange of instruments of ratification at the earliest possible date.

The representatives of Bermuda inquired whether, following the treaty's entry into force, the Secretary of the Treasury would be prepared to certify that mutual assistance under the treaty would be satisfactory for purposes of the Internal Revenue Code rule (Code sec. 927(c)(3)) conditioning a foreign country's eligibility as a situs for Foreign Sales Corporations (FSCs) on the existence of an exchange of information agreement between the United States and that country that either satisfies the statutory requirements of the Caribbean Basin Economic Recovery Act (*see* Code sec. 274(h)(6)(C)) or is certified by the Secretary of the Treasury as carrying out the purposes of the FSC legislation's exchange of information requirements. The representatives of Bermuda also inquired whether mutual assistance provided for in the treaty would be satisfactory for purposes of eligibility for convention tax benefits under the Caribbean Basin Economic Recovery Act. The representatives of the United States stated that, upon entry into force of the treaty, and subject to the understandings contained in the notes, the Secretary of the Treasury, or his delegate, will be prepared to certify Bermuda for purposes of the Internal Revenue Code such that a company organized under the laws of Bermuda may qualify as a FSC. Such certification would be published in the Federal Register and may be terminated effective six months after the date of publication of a notice of termination in the Federal Register. The U.S. Government also stated that, upon entry into force of the treaty, the Secretary of the Treasury, or his delegate, will be prepared to execute on behalf of the U.S. Government an executive agreement satisfying the requirements of the Caribbean Basin Economic Recovery Act, which would incorporate by cross-reference the treaty's and notes' mutual assistance and confidentiality provisions, and would allow persons incurring expenses for attending business conventions in Bermuda to claim deductions for such expenses as

though Bermuda were included as part of the North American area.

The Treasury Department thus takes the position that the treaty's exchange of information rules satisfy the exchange of information requirements of the Caribbean Basin Economic Recovery Act. That Act conditions Bermuda's eligibility for special convention deduction benefits on the existence of an exchange of information agreement between the United States and Bermuda that satisfies the Act's exchange of information requirements.

**Paragraph 12. (Renegotiation provision)**

The representatives of Bermuda emphasized the necessity of including in the treaty additional provisions intended to prevent changes in U.S. income tax treaty policy from adversely affecting the economic position of Bermuda's insurance and tourism industries relative to those of U.S. treaty partners in similar circumstances under current U.S. tax treaty policy. The U.S. representatives were not able to accept such provisions. However, the U.S. Government recognized that insurance and tourism currently play a vital role in the Bermudian economy. If, in the future, the income tax treaty policies of the United States change in a manner which would have a material, adverse effect on such Bermudian business activities, compared with existing circumstances, the U.S. Government indicated that it would be prepared to reopen the discussions in order to take account of such change in policies.

This provision of the notes is similar to, but goes somewhat beyond, provisions relating to tax sparing credits that are included in certain other U.S. income tax treaties with developing countries. The provisions in the other treaties do not make explicit reference to particular industries and generally do not make explicit reference to future changes in U.S. tax treaty policy. Instead, they generally commit the United States to resuming discussions, when circumstances permit, with a view to incorporating provisions in the treaty that will minimize interference with incentives offered by the other country and will be consistent with U.S. income tax policy vis-a-vis other developing countries.

## X. TEXT OF THE RESOLUTION OF RATIFICATION

*Resolved (two-thirds of the Senators present concurring therein),* That the Senate advise and consent to the ratification of the Convention between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) Relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, with a related Exchange of Notes, signed at Washington on July 11, 1986 (Treaty Doc. 99–30), subject to the following reservations:

(1) Effective January 1, 1990, said Convention shall not operate to prevent the imposition by the United States of any excise taxes on insurance premiums paid to foreign insurers, whether or not such premiums constitute income of an enterprise of insurance of a Covered Jurisdiction; and

(2) Said Convention shall in no event operate to prevent the imposition by the United States of any excise taxes on insurance premiums paid to foreign insurers except with respect to insurance premiums that either:

(a) constitute income of an enterprise of insurance of a Covered Jurisdiction carried on by a company in a taxable year in which the company is a controlled foreign corporation within the meaning of section 957(a) or (b) of title 26 of the United States Code as in effect for such taxable year; or

(b) constitute income of an enterprise of insurance of a Covered Jurisdiction carried on by a company in a taxable year in which:

(i) the company is subject to the rules of section 953(c) of the Internal Revenue Code of 1986, and

(ii) the company is a controlled foreign corporation within the meaning of section 957(a) of the Internal Revenue Code of 1986 as modified by section 953(c)(1) of said Code, and

the premiums constitute related person insurance income within the meaning of section 953(c) of the Internal Revenue Code of 1986.



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100TH CONGRESS
*2d Session*

SENATE

EXEC. REPT.
100-24

# PROTOCOL TO THE TAX CONVENTION WITH BELGIUM

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## REPORT

OF THE

## COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ON

THE SUPPLEMENTARY PROTOCOL, TOGETHER WITH A RELATED EXCHANGE OF NOTES, SIGNED AT WASHINGTON ON DECEMBER 31, 1987, MODIFYING AND SUPPLEMENTING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE KINGDOM OF BELGIUM FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, SIGNED AT BRUSSELS ON JULY 9, 1970

SEPTEMBER 22, 1988.—Ordered to be printed

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100TH CONGRESS
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EXEC. REPT.
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# PROTOCOL TO THE TAX CONVENTION WITH BELGIUM

SEPTEMBER 22, 1988.—Ordered to be printed

Mr. PELL, from the Committee on Foreign Relations, submitted the following

## REPORT

[To accompany Treaty Doc. 100-15]

The Committee on Foreign Relations, to which was referred the Supplementary Protocol, together with a related Exchange of Notes, signed at Washington on December 31, 1987, modifying and supplementing the Convention between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed at Brussels on July 9, 1970 (Treaty Doc. 100-15), having considered the same, reports favorably thereon with two understandings and recommends that the Senate give its advice and consent to ratification thereof.

## I. PURPOSE

The primary reason for the negotiation of the proposed protocol is to reduce the tax at source on direct investment dividends from 15 percent to 5 percent, effective January 1, 1988. By thus reducing effective foreign tax rates, the proposed protocol will benefit many U.S. businesses that, particularly after the Tax Reform Act of 1986, have excess foreign tax credits on their foreign income.

In addition to reducing the direct investment dividend rate, the proposed protocol provides rules to prevent nonresidents of the United States and Belgium from enjoying the reduced rates of tax provided in the convention, as amended by the protocol (that is, the proposed protocol prevents a practice commonly referred to as treaty shopping).

## II. BACKGROUND

The proposed protocol to the income tax treaty between the United States and Belgium was signed on December 31, 1987, and

was amplified by an exchange of notes signed the same day. The proposed protocol would amend the current United States-Belgium income tax treaty, which entered into force on October 13, 1972.

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on February 2, 1988.

## III. SUMMARY OF PROTOCOL

The proposed protocol contains the following modifications to the income tax treaty between the United States and Belgium.

*(1) Dividends.*—The proposed protocol replaces present Article 10 (Dividends) of the existing treaty with a new Article 10. The principal change is the reduction of the maximum allowable rate of tax at source on direct investment dividends. The existing treaty requires neither party to reduce its rate of tax at source on dividends below 15 percent. Under the proposed protocol, the maximum allowable rate is reduced to 5 percent in cases where the beneficial owner of the payor is a company that owns at least 10 percent of the voting stock of the payor.

*(2) Anti-treaty shopping provision.*—The proposed protocol adds a provision to the treaty that generally ensures that the reduced rates of tax at source on dividends, interest, and royalties are received only by corporations whose shares are publicly traded in Belgium or the United States and corporations controlled by any combination of U.S. residents, U.S. citizens, Belgium residents, or the countries themselves. The existing treaty does not contain an anti-treaty shopping provision. The proposed anti-treaty shopping provision is similar to those included in recently ratified treaties, but is somewhat less strict than the anti-treaty shopping provision of the 1981 proposed U.S. model income tax treaty (the "U.S. model treaty" or the "U.S. model").

## IV. DATE OF ENTRY INTO FORCE AND TERMINATION

### Entry into Force

The proposed protocol will enter into force on the fifteenth day after the date of the exchange of the instruments of ratification. Once in force, the provisions of the proposed protocol will apply retroactively to dividends, interest, and royalties credited or paid on or after January 1, 1988.

### Termination

The proposed protocol will remain in force as long as the U.S.-Belgium income tax treaty remains in force.

A separate termination provision provides, however, that either country can terminate separately the provisions of the proposed protocol by giving through diplomatic channels at least six months' written notice of termination to the other country at any time after five years from the day on which the proposed protocol enters into force. In this case, the proposed protocol ceases to apply to dividends, interest, and royalties credited or paid on or after the first January 1 that follows after expiration of the six-month period and the provisions of the treaty, as effective on December 31, 1987, shall apply to those amounts.

## V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed protocol on August 9, 1988. The Committee considered the proposed protocol on September 14, 1988, and ordered it favorably reported by voice vote with two understandings that are described below, with the recommendation that the Senate give its advice and consent to ratification thereof.

## VI. COMMITTEE COMMENTS

The Committee on Foreign Relations approved the treaty subject to two understandings. The Committee also expressed its concern with respect to another issue raised by the proposed protocol.

### *Dividends paid by pass-through entities*

The primary reason for the proposed protocol is to reduce the maximum allowable rate of tax at source on direct investment dividends. Under the existing treaty, this rate is 15 percent; the proposed protocol reduces that rate to 5 percent when the beneficial owner is a company that owns at least 10 percent of the voting stock of the payor.

These reductions from the Internal Revenue Code withholding rate of 30 percent are consistent with the U.S. model treaty and consistent with one objective of the U.S. income tax treaties—to eliminate international double taxation by an agreed division of income among two contracting parties. They reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30 percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5 percent rate reflects the view that the source country tax on payments of profits to a substantial nonresident corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment. However, even though the reductions will benefit many U.S. multinationals by reducing their effective foreign tax rates, the reductions raised a concern that when the dividends are paid by a U.S. company which generally does not pay any corporate level income tax they are inappropriate.

A regulated investment company (RIC) is a U.S. corporation that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met (Code secs. 852(b)(2)(D) and (3)). One of those conditions is the requirement that a RIC distribute most of its income. Thus, a RIC is treated, in effect, as a conduit for federal income tax purposes. One purpose of this entity is to allow investors to pool capital to diversify investments, which they might not be able to do otherwise. Dividends paid by a RIC generally are treated as U.S. source income, and thus generally are subject to the U.S. withholding tax of 30 percent when paid to foreign shareholders.

Because a RIC generally does not pay any corporate level U.S. income tax on the earnings it distributes and because it represents for its investors a diversification of portfolio investments, the theory for reducing the maximum allowable rate of tax on U.S. source dividends in the case of dividends paid by a RIC to a

"direct" investor is not present. Whether the investment in the RIC is above or below the threshold level for the direct investor dividend rate, the investment represents in effect an investment in the underlying portfolio investments of the RIC. Therefore, the amount of stock owned in the RIC should be disregarded in determining whether the shareholder is a direct investor.

A real estate investment trust (REIT) is a corporation, trust, or association that is taxable as a U.S. corporation but that, like a RIC, receives conduit treatment for income that is distributed to shareholders if certain conditions are satisfied (Code sec. 857(b)). Like a RIC, a REIT must distribute most of its income to qualify for conduit treatment. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are subject to U.S. withholding tax of 30 percent when paid to foreign owners. When the distributions are composed of rental income, for example, they are not considered rental income to the recipient. Like dividends, U.S. source rental income of foreign persons generally is subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

It has always been the United States' position to preserve the right to tax income from real property to the country in which the income is derived. Thus, the United States always preserves its right to tax real property income derived from the United States in its income tax treaties.

Because a RIC and REIT generally do not pay any corporate level U.S. income tax, and in the case of a REIT, because its income often is composed of a type of income over which the United States maintains its right to tax in its treaties, the Committee does not believe that reducing the U.S. withholding tax rate on dividends as under the existing treaty and the proposed protocol is consistent with the purposes of the dividend rate reductions and maintenance of source country jurisdiction over real property income.

The Committee does not recommend a reservation to the proposed protocol to modify the reduction of the U.S. withholding tax on dividends paid by a RIC and a REIT, however, primarily for two reasons. First, the Committee understands that the Treasury Department considers the reductions in the proposed protocol and in the existing treaty to be inappropriate with respect to distributions from RICs and REITs and that the Treasury Department will seek to modify the reductions in the proposed protocol and in the existing treaty when a new treaty with Belgium is negotiated. Secondly, the Committee does not want to delay the benefits derived by the

proposed protocol for any unnecessary length of time. Therefore, the Committee recommends approval of the proposed protocol with an understanding that the Treasury Department will undertake to negotiate a new convention in an expeditious manner with the objective of modifying the dividend reductions contained in the proposed protocol and in the existing treaty so that the proper amount of source country jurisdiction is retained. Because of the Committee's concern with the inconsistency of the dividend withholding tax rate reductions in the case of distributions by a RIC and a REIT—a concern also expressed by the Chairman of the House Ways and Means Committee in a letter to the Committee—the Committee would not recommend approval of the proposed protocol without the above understanding.

***Implementation of the Tax Reform Act of 1986***

The Tax Reform Act of 1986 ("the 1986 Act") enacted several fundamental changes in the U.S. taxation of U.S. persons doing business abroad and foreign persons doing business in the United States. The proposed protocol does not address any of those changes.

One such change was the imposition of branch level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The 1986 Act provided that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country or the treaty satisfies certain other criteria. (A bill passed by the House of Representatives and pending in the Senate which includes technical corrections to the 1986 Act amends this requirement to provide that only qualified treaty country residents are entitled to treaty waivers or reductions of the branch profits tax.) The 1986 Act also provided that its withholding tax on dividends paid by a foreign corporation that derives a certain amount of its income from a U.S. business would not apply if the earnings distributed were subject to the branch profits tax.

As indicated above, the proposed protocol does not attempt to modify the existing treaty to conform with this change in U.S. tax policy. The proposed protocol does, however, include a provision, which is substantially similar to a provision in the existing treaty, that precludes the United States from imposing its withholding tax on dividends paid by a Belgian company to Belgian residents which would otherwise apply where the Belgian company derives 25 percent or more of its income from a U.S. business. In addition, the existing treaty, and the proposed protocol, do not explicitly provide for the imposition of a branch profits tax.

Although the Committee is concerned about the fact that the proposed protocol does not contain changes conforming the existing treaty to the provisions of the 1986 Act, the Committee is cognizant of the unique desirability of the particular changes that are made to the existing treaty by the proposed protocol. Therefore, to prevent any unnecessary delay, the Committee recommends approval of the proposed protocol with the understanding that the Treasury Department will undertake to negotiate a new convention in an expeditious manner with the objective of coordinating the internal

tax laws of Belgium with U.S. internal tax law and policy as revised by the Tax Reform Act of 1986. In addition, the Committee expects the Treasury Department to conform all U.S. income tax treaties currently in force in an expeditious manner with U.S. tax policy as revised by the 1986 Act and does not intend that the recommendation of this protocol be indicative of its willingness to act upon non-conforming protocols.

***Treaty shopping***

The proposed protocol, like a number of U.S. income tax treaties, generally limits source country withholding tax on dividends, interest, and royalties paid to residents that have a sufficient nexus to the other country. Although the proposed protocol is intended to benefit residents of Belgium and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may attempt to secure a lower rate of U.S. tax by, for example, lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may do this by establishing a subsidiary, trust, or other investing entity in that treaty country which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed protocol differs from the anti-treaty shopping provision of the current U.S. model. While the U.S. model provision is only one of several approaches that the Treasury Department considers satisfactory to prevent treaty shopping abuses, the model provision is nonetheless a standard against which to compare the proposed protocol's anti-treaty shopping provision. The Committee considered whether the proposed anti-treaty shopping provision effectively forestalls potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed protocol is more lenient than the comparable rule in the U.S. model and other U.S. treaties. The U.S. model allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed protocol (like several newer treaties and an anti-treaty shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country (and citizens of the United States). Thus, this safe harbor is considerably easier to enter under the proposed protocol. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed, since the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty shopping article of the proposed protocol, which is coupled with the ownership requirement to achieve rate reduction benefits, is the "base erosion" rule. This requirement is met only if more than 50 percent of the gross income

of the person claiming benefits is not used directly or indirectly to meet liabilities for interest or royalties to persons who are not residents of Belgium or the United States, citizens of the United States, or the countries themselves. This rule, commonly referred to as the "base erosion" rule, is necessary to prevent a corporation, for example, from distributing most of its income through the use of deductible payments to persons not entitled to benefits under the treaty. Because the rule is limited to payments of interest or royalties to persons not entitled to benefits, the provision may not be broad enough to achieve its intended purpose. The Committee understands that the Treasury Department is continuing to examine the scope of the base erosion rule to ensure that its breadth is adequate. It may be that other forms of payments, such as management fees or payments under various compensation arrangements, will have to be included when the treaty is renegotiated.

Another provision of the anti-treaty shopping article differs from the comparable rule of the U.S. model, but the effect of the change is less clear. The general test applied by the U.S. model to deny benefits is a broad one, looking to whether the acquisition, maintenance, or operation of an entity had "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed protocol contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) The practical difference between the two tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the trade or business test could be interpreted to require a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the active business test (i.e., would operate to deny benefits in potentially abusive situations more often).

Finally, the proposed protocol provides an exception that preserves benefits for publicly traded companies. Under this test, a company that is a resident of one of the countries and either (1) in whose principal class of shares there is substantial and regular trading on a recognized securities exchange, or (2) more than 50 percent of whose shares of each class is owned by a resident of that country in whose principal class of shares there is also substantial and regular trading on a recognized securities exchange, would be entitled to the benefits of the reduced rates of tax at source on dividends, interest, and royalties regardless of where its actual owners reside. The terms "substantial" and "regular" are not defined in the proposed protocol, nor does the Treasury Department's technical explanation detail any standard for these terms. Presumably then, the terms would be defined pursuant to local law. The regulations under Code section 897, relating to an exception from the taxation of real property income for certain stock that is regularly

traded on an established securities market, provide a definition of "regular" for that purpose. Also, the 1986 Act enacted a branch profits tax that allows certain treaty-protected residents to avoid being subject to the tax if their stock is "primarily and regularly" traded on an established securities market. Temporary regulations have been promulgated to define the exception from the branch profits tax, and it may be that for practical reasons the definition provided when the regulations are finalized could be used for interpreting the substantial and regular test under the proposed protocol.

With respect to the active trade or business provision of the proposed protocol's anti-treaty shopping article, the Committee is concerned with its application to Belgian Coordination Centers. The Committee understands that a Belgian Coordination Center is entitled to special tax benefits that result in it paying little or no tax to Belgium. For this reason, the Committee does not believe that the waiver (or reduction) of source-basis taxation by the United States is appropriate. The Committee also is aware that the Treasury Department generally does not believe that a Belgian Coordination Center can be engaged in an active trade or business which would qualify it under the proposed protocol's provision, although the Committee believes (and understands that the Treasury Department shares the view) that the determination on this issue as on other similar issues will have to be assessed after presentation of the facts of each case. Moreover, because the existing treaty generally permits the United States to tax U.S. source interest at a 15 percent rate, the Committee believes that use of a Belgian Coordination Center by a nonresident of Belgium or the United States to derive treaty benefits may at the present time be limited. To the extent that the maximum allowable rate of tax on U.S. source interest is ever reduced or that Belgian law is changed to allow a Belgian Coordination Center to own stock in U.S. companies or license intangible property more than is presently allowed, the Committee would be extremely concerned about a Belgian Coordination Center, or other entity that is subject to little or no Belgian tax, that is not owned by Belgian or U.S. residents being entitled to U.S. tax treaty benefits. The Committee believes that the Treasury Department, in its renegotiation of the existing treaty, should examine this issue more closely to ensure that the primary objective of U.S. treaties—to eliminate double taxation, rather than all taxation—is preserved.

With respect to the other provisions of the proposed protocol's anti-treaty shopping article, the Committee expects the Treasury Department to satisfy itself that those provisions adequately deter treaty shopping abuses. The Committee believes that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. In this regard, it is notable that the proposed protocol would add an anti-treaty shopping provision to the existing treaty. Although drafted to limit foreseeable cases of abuse, changes in Belgian law could invite new abuses. The Committee emphasizes that any such changes in Belgian law could require a careful reexamination of the adequacy of the proposed protocol's anti-treaty shopping article.

## VII. BUDGET IMPACT

The Committee has been informed by the Joint Committee on Taxation that the effect of the proposed protocol is estimated to decrease annual budget receipts by $500,000.

## VIII. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and Belgium is presented below, followed by an explanation of the notes exchanged when the proposed protocol was signed.

### Article 1. Dividends

The proposed protocol replaces the present dividend article with a new article whose principal change lowers the maximum allowable rate of tax at source on direct investment dividends. This lower rate is consistent with the rate contained in the U.S. model and recently ratified treaties. The other treaty provisions pertaining to the taxation of dividends are modernized by the proposed protocol, bringing the treaty's dividend article into closer conformity with the U.S. model.

The existing treaty allows both the United States and Belgium to tax dividends paid by a corporation of one country to a resident of the other. The maximum allowable rate of tax at source on dividends is 15 percent, regardless of the recipient's ownership interest in the dividend payor, unless the shares on which the dividends are paid are effectively connected with a permanent establishment in one of the countries. In this latter case, the dividends are taxable as business profits (Article 7 of the treaty). The existing treaty also precludes one country from taxing dividends paid by a corporation of the other country to residents of the other country, unless the shares on which the dividends are paid are effectively connected with a permanent establishment in the first country.

Under the proposed protocol, dividends paid by a corporation of one country to a resident of the other can continue to be taxed by both the United States and Belgium. However, when the corporation paying the dividends is resident in one country and the beneficial owner of the dividends is resident in the other, the maximum allowable rate of tax is 5 percent if the beneficial owner is a company that owns directly at least 10 percent of the voting stock of the corporation paying the dividends. In other cases, the maximum allowable rate continues to be 15 percent. These rules do not restrict the right of a country to tax the profits out of which dividends are paid. This difference in treatment of dividends paid to "direct" investors and to "portfolio" investors (i.e., those company investors not owning at least 10 percent of the payor's voting stock) is consistent with the treatment provided by the U.S. model.

Like the U.S. model treaty, the proposed protocol defines "dividends" as income from shares or other rights which participate in profits and which are not debt claims. To conform with Belgium law, the term also includes income from "jouissance" shares or "jouissance" rights, mining shares, or founders shares which participate in profits and which are not debt claims. Dividends also in-

clude income from other corporate rights which is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. Under this provision, each country may apply its rules for determining when a payment by a resident company is on a debt obligation or an equity interest. Finally, at Belgium's request, the term dividends includes income—even if paid in the form of interest—which is taxable as income from capital invested by the members of a company, other than an incorporated company, which is a resident of Belgium. This latter inclusion in the term dividends, the inclusion of which is substantially similar to a provision in the existing treaty, allows Belgium to exercise an anti-abuse rule in its law by treating as dividends, regardless of how remitted, income paid by an unincorporated Belgian company with respect to capital invested by its owners. The Treasury Department's technical explanation gives as an example of this rule interest paid on loans made to a closely held general partnership by one or more of its partners.

Consistent with the U.S. model and the existing treaty, the proposed protocol's limitations on source country dividend tax do not apply under the proposed protocol if the beneficial owner of the dividend carries on business through a permanent establishment in the source country and the shareholding with respect to which the dividends are paid forms part of the assets of the permanent establishment. The proposed protocol also modernizes the existing treaty by not applying the proposed protocol's limitations on source country dividend tax if the beneficial owner of the dividend performs in the source country independent personal services from a fixed base situated in that country and the shareholding with respect to which the dividends are paid forms part of the assets of the fixed base. In these cases, the dividends are not taxed under the provisions of this article, but as business profits (Article 7 of the treaty) or as income from independent personal services (Article 14 of the treaty), respectively.

The proposed protocol limits the right of a country to tax dividends paid by a company resident in the other country to residents of that other country. Generally, the country in which the company is not resident may only tax dividends paid by a company resident in the other country to residents of that other country if the shareholding with respect to which the dividends are paid forms part of the assets of a permanent establishment or a fixed base situated in the first mentioned country. However, as indicated in the technical explanation, if the United States is the first mentioned country, it can tax dividends paid by a Belgian company to a U.S. citizen resident in Belgium; the United States reserves the right to tax its citizens as if the convention had not come into effect (paragraph 1 of Article 23).

This provision, which is inconsistent with the U.S. model to the extent it precludes a country from taxing dividends paid to the other country's residents if certain income thresholds are met by the distributing company, precludes the United States from imposing its withholding tax which would otherwise apply to dividends paid to Belgian residents by a Belgian company that derives 25 percent or more of its income from a U.S. business.

As under the existing treaty, the proposed protocol allows Belgium to tax, pursuant to its internal law, dividends paid by a company which is a resident of Belgium to a company not resident in Belgium but where the shareholding forms part of the assets of a permanent establishment situated in Belgium.

**Article 2. Cross Reference**

This article merely corrects a cross-reference in the existing treaty caused by the proposed protocol.

**Article 3. Limitation on Benefits**

The proposed protocol contains a provision which is intended to limit the benefits of the reduced rates of tax at source on dividends, interest, and royalties to persons who are entitled to those benefits by reason of their residence in the United States or Belgium. The present treaty does not contain such a provision. The new provision is somewhat less strict than the corresponding provision of the U.S. model treaty. It is similar to, but not identical to, the limitation of benefits articles included in the recently ratified U.S. income tax treaties with Barbados, Australia, and New Zealand.

The treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Belgium as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. Such use is known as "treaty shopping," and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate the taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions) either through relaxed tax provisions in the resident country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

As indicated above, the proposed new anti-treaty shopping article of the protocol is intended to limit the benefits of the reduced rates of tax at source on dividends, interest, and royalties to bona fide residents of the two countries. This would be accomplished by providing that a person other than an individual (such as a corporation, partnership or trust) is not entitled to the benefits of the reduced rates of tax at source on dividends, interest, and royalties unless it satisfies any one of an ownership and "base erosion" test, a good business purpose test, or a public company test.

Under the ownership and base erosion test two conditions must be satisfied. First, more than 50 percent of the beneficial interest in the person (in the case of a company, more than 50 percent of the number of shares of each class of shares) must be owned direct-

ly or indirectly by any combination of one or more individual residents of Belgium or the United States, citizens of the United States, or the governments of the United States or Belgium. This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest, or royalties paid to a Belgium company that is controlled by individual residents of a third country. This rule is not as strict as that contained in the U.S. model, which requires 75 percent ownership, by residents of the person's country of residence, to preserve benefits.

Second, reduced rates of tax at source on dividends, interest, and royalties is available only if more than 50 percent of the gross income of the person is not used directly or indirectly to meet liabilities for interest or royalties to persons who are not residents of Belgium or the United States, citizens of the United States, or the governments of Belgium or the United States. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing most of its income through the use of deductible payments to persons not entitled to benefits under the treaty. Gross income for this purpose is defined to mean: in the case of the United States, gross income as defined in the Internal Revenue Code of 1986, as may be amended from time to time, without regard to the geographic source of the income; and in the case of Belgium, gross receipts, or in the case of a manufacturer or producer of goods, gross receipts reduced by the direct costs of labor and materials attributable to the manufacture or production and paid or payable out of those receipts. This provision is substantially similar to that in the U.S. model treaty.

Under the good business purpose test, denial of reduced rates of tax at source does not occur if the resident entity's dividends, interest, or royalties are derived in connection with, or are incidental to, the active conduct of a trade or business in the residence country. However, this exception does not apply (and benefits are therefore denied) to a business the principal activities of which are making or managing investments in the source country. This active trade or business rule replaces a more general rule in the U.S. model treaty and most recent U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty. The Committee understands that the Treasury Department does not believe that a Belgian Coordination Center, which receives special tax benefits in Belgium, generally can avail itself of the good business purpose test. In the case of, for example, a Belgian Coordination Center that does not satisfy the ownership or base erosion tests and that receives dividends, interest, or royalties from the United States, this view generally would result in the Belgian Coordination Center not being entitled to reduced rates of U.S. tax under the treaty (unless it satisfied the public company test).

Under the public company test, a company that is a resident of one of the countries and either (1) in whose principal class of shares there is substantial and regular trading on a recognized securities exchange, or (2) more than 50 percent of whose shares of each class is owned by a resident of that country in whose principal class of shares there is also substantial and regular trading on a recognized securities exchange, would be entitled to the benefits of the reduced rates of tax at source on dividends, interest, and roy-

alties regardless of where its actual owners reside. The term "recognized securities exchange" means any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, the NASDAQ system owned by the National Association of Securities Dealers, Inc., the Belgium stock exchanges, and any other securities exchange agreed upon by the competent authorities of the two countries.

**Article 4. Entry into Force**

The proposed protocol enters into force on the fifteenth day after the date of the exchange of the instruments of ratification. Once in force, the provisions of the proposed protocol will apply retroactively to dividends, interest, and royalties credited or paid on or after January 1, 1988.

**Article 5. Termination**

The proposed protocol remains in force as long as the U.S.-Belgium income tax treaty remains in force.

A separate termination provision provides, however, that either country can terminate separately the provisions of the proposed protocol by giving through diplomatic channels at least six months' written notice of termination to the other country at any time after five years from the day on which the proposed protocol enters into force. In this case, the proposed protocol ceases to apply to dividends, interest, and royalties credited or paid on or after the first January 1 that follows after expiration of the six-month period and the provisions of the treaty, as effective on December 31, 1987, shall apply to those amounts.

***Exchange of Notes***

At the signing of the proposed protocol, notes were exchanged confirming the understanding of the U.S. and Belgium delegations as to the meaning of "beneficial interest", as that term is used in the anti-treaty shopping article. As indicated above, the proposed protocol adds an anti-treaty shopping article. Unless other conditions are satisfied, the proposed protocol precludes a person (other than an individual) from claiming reduced rates of tax at source on dividends, interest, and royalties unless more than 50 percent of the "beneficial interest" in the person is owned directly or indirectly by any combination of one or more individual residents of Belgium or the United States, citizens of the United States, or the governments of Belgium or the United States. The Belgium and United States delegations agreed that the French and Dutch language texts of the anti-treaty shopping article would incorporate the English meaning of the term "beneficial interest." As intended, more than 50 percent of the rights to income and other economic rights in the person claiming treaty benefits would have to be owned by qualifying persons. As an example, the notes stated that in the case of a trust claiming treaty benefits, more than 50 percent of the interests held by beneficiaries of the trust must be held by qualifying persons. The identities of the legal owners of the trust would be irrelevant for this purpose, the notes stated.

## IX. TEXT OF THE RESOLUTION OF RATIFICATION

*Resolved, (two-thirds of the Senators present concurring therein,)* That the Senate advise and consent to the ratification of the Supplementary Protocol, together with a related exchange of notes, signed at Washington on December 31, 1987, modifying and supplementing the Convention between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Brussels on July 9, 1970 (Treaty Doc. 100–15), subject to the understandings that:

(1) the Treasury Department will effect the negotiation of a new Convention in an expeditious manner with the objective of modifying the tax rates on dividends specified in paragraph 2 of Article 10 (Dividends) to deny inappropriate relief from taxation at source on dividends paid by Regulated Investment Companies, Real Estate Investment Trusts, and any other U.S. corporations that essentially receive conduit treatment for U.S. income tax purposes; and

(2) the Treasury Department will effect the negotiation of a new Convention in an expeditious manner with the objective of coordinating the internal tax laws of Belgium with U.S. internal tax law and policy as revised by the Tax Reform Act of 1986.



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